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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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THE MARKET On May 31 the two Averages established post-crash recovery highs. On that day Industrials advanced to within 8 points of their 1961 all-time peak of 734.91, Rails to within 18¢ of their 1959 high of 173.56.

As noted in the last Letter, the recent Industrial rise represented the fourth time within two years that the senior Average has entered the 720-734 area. In the three previous instances, warning of impending danger was provided by divergence between Industrials, Rails and the advance-decline ratio. Those three performances were in contrast with the most recent market action in that no divergence appeared at or around last month's recovery high.

On June 7 the two Averages dropped sharply (see Chart No. 1), and this was followed by a further steep decline on Monday (June 10). "One swallow does not make a spring", and one decline hardly spells disaster. But a few things about the current weakness are worth discussing. First, the Industrial Average has turned down at the termination of what appears to be a huge "rising wedge" pattern (this phenomenon was described in detail in Letter 219). A rising wedge denotes a situation in which buying power is steadily diminishing, and declines from such structures may be drastic.

Secondly, the weakness has occurred within a few percentage points of the old highs. If weakness now becomes widespread, those who have loaded up with stocks might rush to sell on the theory that "since the Averages have refused to better the highs, a bear market is probably still in existence."

Third is the fact that the decline started from the 3% zone of average yields on the Industrial Average (the time-honored danger area). This means (see later section) that the D-J Industrial Average now provides a yield almost identical to that afforded by U. S. Treasury bills (the latter are probably the safest investment obtainable anywhere).

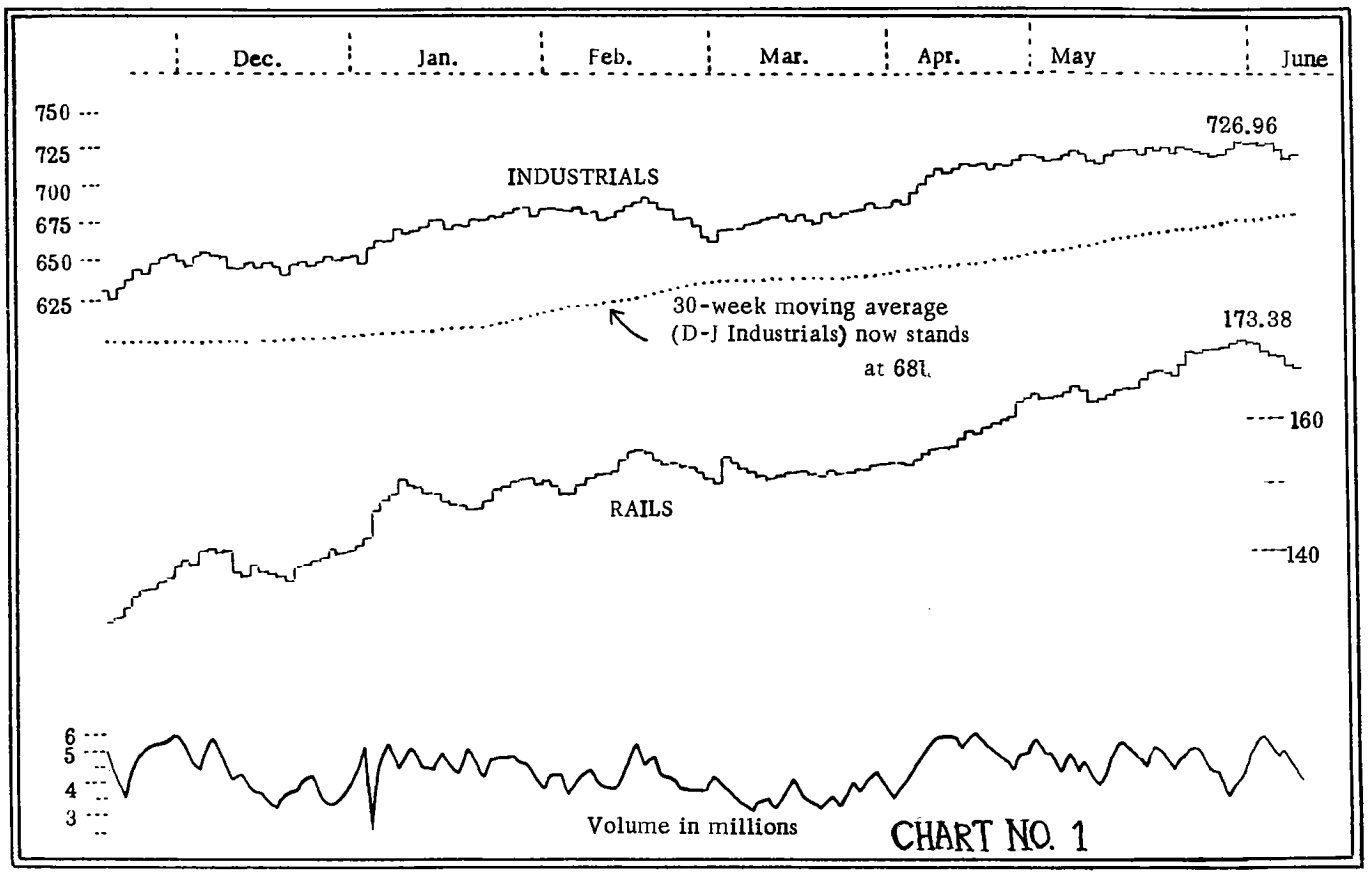
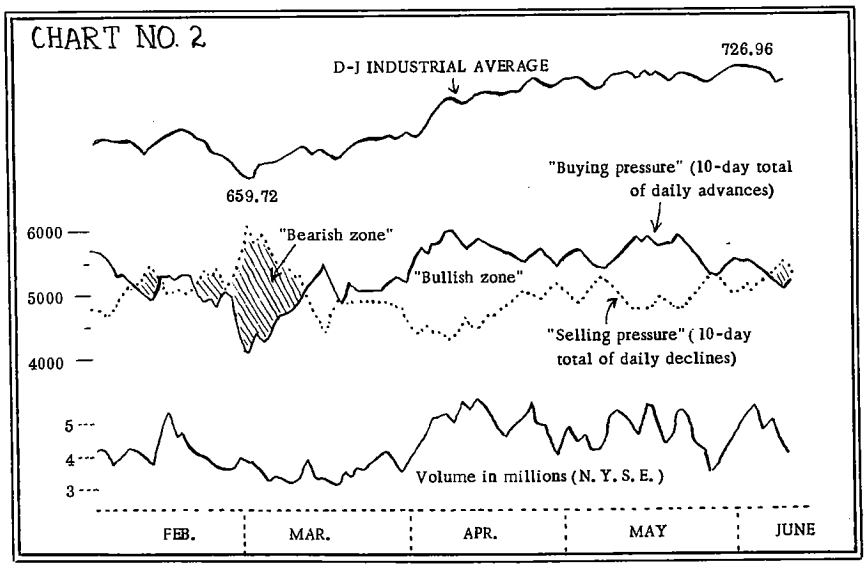


CHART NO. 1

From the plus side of the ledger, it should be noted that the great majority of important declines were prefaced by some sort of "disagreement" among the Averages (i.e., a non-confirmation, a divergence). So far, all we can say is that the two indicators rose to recovery highs on May 31, then turned down. Even if trouble is "around the corner", the odds would seem to favor another assault on the May 31 peaks (at which time divergence may or may not occur).

What do we watch for now? From the standpoint of Dow's Theory, the first decline can never tell the story. It is the levels at which the first decline terminates which assume importance. Following whatever decline lows are now being established, there will be a rally. If that rally succeeds in taking both Averages to new recovery highs, the market will have issued its "all clear" signal. However, if one or both Averages fail to go to new highs, and the two indicators then turn down and violate the earlier decline bottoms, it will be obvious that the secondary trend has turned down.

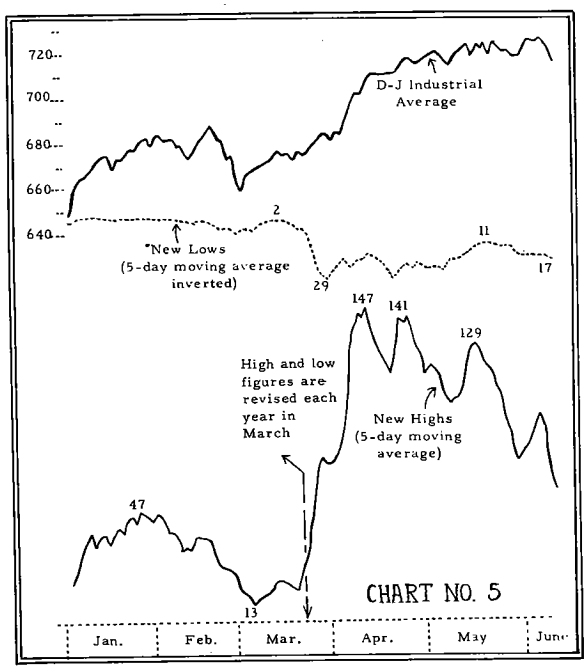
BUYING AND SELLING PRESSURE On June 7 the selling pressure line rose to the dominant position above the buying line (Chart 2). Thus the bear forces have (at least temporarily) taken command. From the standpoint of this study, two things will have to be watched: (1) the longer the selling line holds above buying, the more bearish the underlying situation, and (2) the greater the volume generated while the selling line is dominant, the greater the downside pressure.



So far, volume has receded very noticeably as the selling line climbed above the buying line. A continued contraction of volume as prices decline would, of course, be an encouraging sign.

HIGHS AND LOWS One study which I have been watching carefully is the daily new high- new low index. Chart No. 5 shows a five-day moving average of daily new highs and daily new lows (the latter is inverted). Note that despite successive new recovery peaks on the Industrial Average, the new high index seems to have "topped" at 147 on April 15, 1963. A second peak of 141 was struck on April 24, and a third lower peak of 129 was touched as recently as May 15. Since then the new high index has contracted sharply.

During a powerful bull movement, more and more stocks break out of their patterns and rise to new highs. If the strength continues, the breakouts continue to advance to new highs, while an increasing number of other issues join the upside parade. But when the main upward momentum begins to diminish, the new high list slowly contracts. This contraction process can consume a good deal of time, however. For instance, the new high index topped out on November 14, 1961, but it was not until March, 1962 (four months later) that the market began heading down in earnest. Comparable lead time in the current market would mean that trouble could appear about August.



What constitutes the signal for the real downturn? Usually, it is a steady increase in the new low sector of the index. As seen on the chart, new lows have not yet expanded. On March 28, 1963, the new low index showed a high total of 28. I would consider any five-day average beyond 28 on the new low index as a danger signal. By the same token, however, as long as the five-day average of new lows holds above 28 (it is now 16) we can say that the market is on "firm ground".

TIGHTENING FUNDS There are three main catagories in the U. S. balance-of-payments: (1) Government spending for military and foreign aid, (2) private capital inflow and outflow, and (3) import and export of goods. Of these three, the only favorable sector is the third, or the excess of goods shipped out over those brought in. The biggest single item in this import-export catagory and the one which is by far the most important is finished goods. But even here, the story is an umpleasant one. In 1956 U. S. exports of finished goods ran about four times as much as imports of finished goods. But in 1962 this favorable trade balance

had dropped to the point where finished goods exports were only twice those imported. What is happening is that Germany, France, Italy and the countries of Western Europe are becoming increasingly larger factors in world markets while the U. S. and England are becoming smaller.

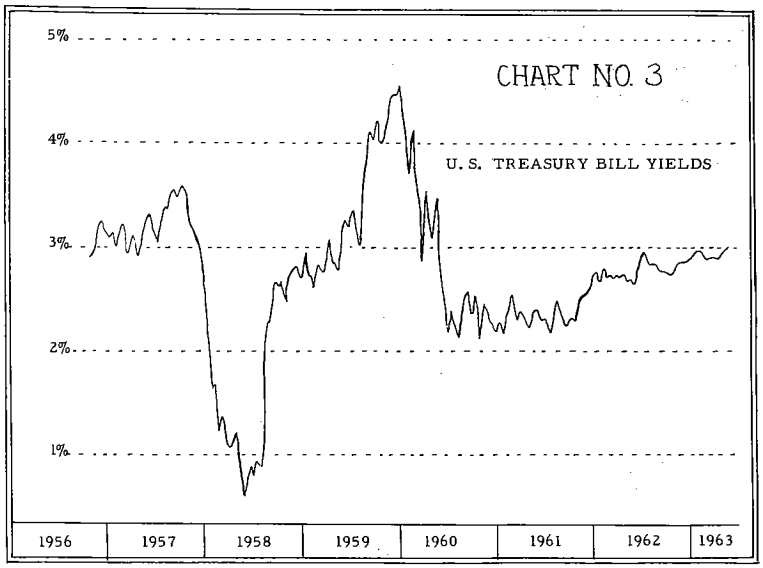
Much has been made of the fact that the U. S. gold outflow this year is running behind the comparable period of last year. But a good part of this "favorable" development is a result of exchange gimmicks and special "agreements" made between the U.S. Treasury and foreign central banks. Despite the agreements, however, foreign-held dollars (not yet exchanged for U. S. gold) continue to pile up here. For instance, U. S. Government securities held for foreigners rose last week by $77 million to $7. 8 billion, and this made a total increase of $2. 1 billion since last year! If we take the first five months of this year as against the same period last year, the comparison is rather horrendous. In the January through May period of 1963, U. S. securities held for foreigners increased $925 million against a decrease of $279 million in the comparable period of 1962. The conclusion is inescapable -- at some point (unless there is a drastic reversal of trend) we are going to see a real run on the dollar. Sooner or later, some foreign government is going to start grabbing for its gold.

But which foreign nation would dare "upset the applecart"? The answer could be -- France. One of the few men to whom de Gaulle will listen is Jacques Rueff, the famous French economist. According to an article in the Paris Weekly, France Observateur, Mr. Rueff told a group of journalists in Paris that the dollar should seek its own level:

> "It is necessary to refuse to help the Americans maintain their overvalued currency at its present rate of exchange. If the United States balance of payments shows a chronic deficit, if the reserves at Fort Knox sink lower every year, this proves that an economic and financial process which one must not thwart is under way. Instead of supporting the American currency by reimbursing it through prepayment of long-term indebtedness, as Finance Minister Giscard d'Estaing is now doing; instead of contributing, as the Bank of France is now doing, to the pool at Basel which permits the dollar to beat off speculative assaults, we should let the American currency decline to its natural level."
>
> To Mr. Rueff the fact that the United States has only $16 billion in gold reserves to cover $12 billion worth of public foreign credits, $10 billion worth of private foreign credits and $11 billion worth of domestic currency, amounts to sheer heresy.

In the face of this type of thinking and in the face of a continuing dollar deficit in this country -- who is to predict what next month will bring?

Treasury bills are the short-term debt of the U. S. Government (they mature in less than one year), and they are considered the most sensitive of all debt instruments. Last week, for the first time in three years (since mid-1960), the yields on U. S. Treasury bills rose to the 3% level. This phenomenon should be taken as a definite sign of tightening money. The accompanying chart (Chart No. 3) traces recent bill-yield history.



During 1957-58 bill yields were allowed to sink below 1%. The Federal Reserve was attempting to make money "cheap" in an effort to combat the recession. But during the subsequent economic recovery, the first gold scare struck the country, and money suddenly tightened. Bill yields soared (see chart and the "Magic Fives" (Treasury Notes yielding 5% annually) became an overnight sensation. A second recession began in early 1960, but this time bill yields dropped only to the 2% level. The fear of continuing gold losses was a factor which prevented the Fed from allowing money to become as cheap as it was in 1957-58. The latest part of the story is graphically illustrated on the chart. Since 1960 the yield on Treasury Bills has been slowly creeping higher, despite talk of an "incomplete" or "unsatisfactory" recovery from the 1960 recession.

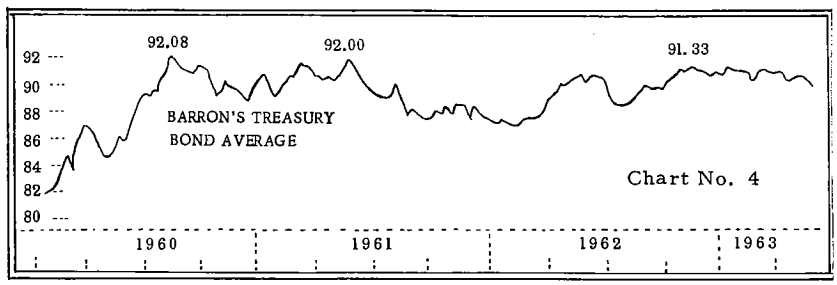


Chart No. 4 tells more of the same story. Last week Barron's Treasury Bond Average dropped below its February 22, 1963 decline low of 90. 15 to its lowest

level in nine months. Letter 218 drew attention to the triple top in the Treasury Bond Average, a top which began in August, 1960, when the Treasury Average struck a high of 92.08. The recent 91.33 (October, 1962) peak was the third attempt by this Average to better the 1960 high. The picture at present is clear enough -- Treasury debt (i.e., bonds, notes and bills) are heading towards lower prices and higher yields.

Even in unsophisticated circles, the trend of the money market is taken as a tacit admission by the Fed that the balance-of-payments problem in this country is not being solved. Despite pious words, political promises and the gimmicks of money managers, the pile-up of foreign-held dollars continues.

In this writer's opinion, the balance-of-payments situation is the single biggest threat hanging over the U.S. economy and stock market today. It is a problem that is not on the way to being solved. "Business is O.K.; why worry about the same old things?" asks the investor. But ironically, an expanding economy here means higher prices for U.S. goods, pricing ourselves further out of the world markets, higher U.S. imports and lower U.S. exports, and in turn an even further deterioration in our balance-of-payments.

The public and most professionals are sick of or bored with the whole gold outflow problem. They have heard about it for three years now, and it's beginning to sound like the cry of "wolf!" All this notwithstanding, I urge readers to pay the cloest attention to the payments situation. It is a very real threat -- and it could become critical at any time.

What would constitute an early signal of danger on the payments front? In my opinion, such a signal would be Treasury bill yields rising into the 4% zone again. For this reason, I intend to keep subscribers informed as to any important changes in U.S. treasury bill yields in coming weeks and months.

STOCKS Of 444 stocks now being tabulated at this office each week, 384 (86%) are now holding above their moving average. Last week a number of secondary issues "moved out" and this increased the bullish percentage considerably.

Of all groups, autos, airlines, and aluminums are now showing strongest on a relative strength basis. Meanwhile, aircrafts remain weakest on a relative strength basis, with such issues as North American, General Dynamics and United Aircraft appearing particularly weak.

I enclose weekly charts of two stocks below, American Home Products and Zenith. Both issues have shown reversals in their relative strength lines while forming huge ascending triangles. Over the past week both stocks have broken out of their triangles, and they are now in a position to be bought.

A good many of the speculative issues are now moving out of impressive bases. These include Sperry Rand (and the Sperry Warrants, traded on the American), Ampex and Universal Match. These three stocks represent an excellent speculative "package" at this time.

Charts on this page courtesy of Traders Research, P.O. Box 2466, St. Louis 16, Missouri.